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INFORMATIONAL BRIEFING ON NEED TO EXAMINE ECONOMIC POLICY ASSUMPTIONS UNDERLYING CIVILIAN NATIONAL DEFENSE STOCKPILE GOALS AND METHODOLOGY

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I. FEMA NATIONAL DEFENSE STOCKPILE GOALS

Current Stockpile Goals:

- 69 materials, ranging from cobalt, chromite and titanium -- to vegetable tannin and iodine. (U)

- Dollar value of stockpile goals (billions) 1/:

  - Total stockpile goal..... $20.1
  - Current inventory..... 12.5
  - Less inventory in excess of goals 2/..... -4.9
  - Inventory toward goal..... $7.6
  - Percent of goals unfilled..... 62% 3/

- Examples of stockpile goals (thousand short tons):

	Titanium	Copper	Cobalt	Tungsten	Iodine
Military.....	191	0	26	8	0
Civilian.....	2	952	20	22	3
Total.....	193	952	46	30	3 (U)

1/ Based on data in the President's Minerals Policy Statement, April, 1982.
2/ Primarily tin, silver and tungsten.
3/ 20% of unfilled goals are for civilian needs, 20% for defense needs. (U)

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Relevance of Stockpile Goals and Projection Methodology to Routine Administration Economic Policy Decisions:

- Drives annual FEMA stockpile budget and Congressional stockpile add-ons (e.g. Schmitt amendment to purchase $250 million in low priority copper). (U)

- Frequently is a factor in Trade Expansion Act (Section 232) determinations (e.g. ferroalloys, industrial fasteners and machine tool cases). (U)

- Used to support case for Defense Production Act subsidies. (1983 House bill, H.R. 13, provides $6.75 billion over 5 years justified partially on unfilled stockpile goals. Same bill nearly passed House in 1982.) (U)

- Used to bolster ad hoc stockpile barter proposals (e.g., government property for aluminum.) (U)

- Underlying econometric model and projection methodology now in process of update and revision (comprehensive update on 2-4 year cycle). (U)

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II. FEMA METHODOLOGY TO ESTABLISH CIVILIAN STOCKPILE GOALS

Basic Methodology

- Defense and civilian requirements to support two-front war for three years following one year mobilization warning. (Defense requirements are not covered in this review.) (U)

- Stockpile materials requirements projected by modifying Chase Econometrics "base case" peacetime econometric projection of GNP to create a wartime economy. Various GNP subcomponents adjusted to account for impact of: (U)

  - DOD military materials demand increment; (U)
  - Wartime economic policy tools designed to optimize defense related output, civilian economy contraints and overall economic performance; (U)
  - FEMA projections of wartime civilian materials demand changes under constrained policies; (U)
  - Total materials supply based on Interior estimates of domestic production and import availability. (U)
  - Foreign supplier reliability based on FEMA rankings of State Department peacetime political judgments; (U)

- Scenario implicitly assumes shut-down of Persian Gulf, most industrial activity in NATO and Asian war-zone nations. (S)

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Methodological Weakness and/or Contradictions

- Civilian economy and personal consumption may be too robust given war tax financing assumption, military demands on output, and potential strategic commodity bottlenecks. (U)

- Efficacy, interactive effects and economic consequences of wartime economic policy tools not explicit or rigorously tested. (U)

- Weak to non-existent price/supply/demand relationships for basic materials and industrial commodities. (U)

- Questionable domestic and foreign raw material supply estimates for many key commodities. (U)

- Downstream impact of industrial capacity limits (e.g. steel) and strategic commodity bottlenecks (e.g. oil) not reflected in macro-economic projections. (U)

- Contradictions and inconsistencies may give systematic upward bias to stockpile goals and peacetime policy actions/costs tied to them. (U)

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1) Wartime Economic Policy Tools

- In order to accommodate a 290% increase in real defense output over a four year period, the planning model assumes a variety of wartime economic policy adjustments designed to allocate resources to wartime objectives and balance overall economic performance. For the 1979-82 planning model from which current stockpile goals have been derived, these policy adjustments include: (U)

  - A 50% cut in the Federal Reserve discount rate in order to facilate an "active case" monetary policy and a 23% expansion of nominal GNP in the first year of the war; (U)

  - Stringent credit allocation policies designed to reduce real consumer durable spending by 45% by the third year of the war. (U)

  - About a 45% increase in average personal income and corporate tax rates plus major increases in indirect business taxes and an auto excise tax to accomplish a war financing policy based on 65% taxes and 35% borrowing. (U)

  - Selective capital investment incentives (ITC and rapid depreciation) to facilitate a 56% real increase in business equipment investment over 4 years (outside the defense production base). (U)

  - Direct DOD financing of most of the wartime production base needed to produce military goods, including $775 billion (1982$) in government financed plant and equipment over four year. (U)

  - Various direct interventions including construction price controls, consumer goods rationing, foreign exchange and investment controls and import/export controls. (U)

  - These policy measures have not been rigorously tested, and they have not been reviewed by senior economic policy officials during the Reagan Administration. (U)

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2) Civilian GNP Estimates and Materials Requirements

- Methodology for the current projection period (1979-82) results in lax and sweeping definition of "essential" civilian requirements to support war mobilization which includes: (U)

	Direct and Indirect Defense	Essential Civilian	Basic Industrial	
			Protected in Stockpile	Phantom* Tier
Percent of wartime GNP	15%	53%	25%	7%
% of Materials Requirement Protected by Stockpile	100%	100%	100%	0%
Types of Items	All defense weapons, uniforms, food, plus indirect needs for their production	Housing, food, energy, business investment, TV repairs, barber-shops, alcoholic beverages	60% of new cars, stationery, most services, 37% of boats, tobacco products	40% of new cars, jewelry, watches 63% of boats, amusements

* FEMA GNP assumptions imply material available but not protected by stockpile. (U)

- Projected wartime economy is 122% of actual 1980-82 levels (115% above for civilian) and stockpile protection covers 93% of this activity. Thus, current stockpile goals

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- Leads to excessive assumptions for aggregate personal consumption expenditures (PCE) including: (U)
  - 7 percent annual wartime PCE growth rate -- higher than any peacetime year since 1946. (U)
  - Preliminary data from the 1983 goals project only 20 percent decline in civilian auto and recreational vehicle output compared to 98 percent in WWII -- and presumably in the face of a draconian civilian gasoline shortage. (U)
  - FEMA wartime PCE levels exceed actual 1980-82 PCE by 10 percent. (U)
- Assumptions generate total wartime GNP that resembles high-throttle "guns and butter economy" and resulting excessive estimates of materials demand. Compared to pre-war base, model assumes: (U)
  - 290 percent real increase in defense output. (U)
  - 17 percent real increase in civilian output compared to 12 percent decline in WWII. (U)
- Real GNP grows at 9% annually while inflation declines -- even though U.S. oil supplies are only about 50% of normal levels. (S)
- Other questionable assumptions include:
  - Doubling of pre-war money supply growth rate but lower than pre-war inflation. (U)
  - 70 percent corporate tax rate but 56 percent real increase in civilian equipment investment. (U)
  - Manufacturing labor productivity rises 13.7% per year while the unemployment rate falls to 1.7% by the third year, and metals manufacturing utilization

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3) Industrial Capacity Limits and Strategic Bottlenecks (U)

- o US petroleum consumption implicit in GNP levels increases 20-25 percent over peacetime of 15-16 MB/D level. But multi-year war scenario almost guarantees that North Sea, North Africa and Persian Gulf knocked out of production (54 percent of CIA-estimated free world capacity). (U)

- o The resulting 42 percent reduction in US civilian petroleum supplies not consistent with following assumptions used to generate sector materials requirements: (S)

    - o Domestic civilian motor vehicle and equipment (cars, trucks, buses) output at 120% of prewar levels. (U)

    - o Civilian aircraft production at 140-190% of prewar levels. (U)

    - o Automotive supply and servicing demands at 170 percent of pre-war level while gasoline supply at only about 58 percent of normal. (S)

    - o Either administrative or price rationing of civilian petroleum supply could drastically reduce FEMA's estimates of petroleum-dependent civilian output. (U)

    - o Consumer-related stockpiles of copper, cobalt, chromite, etc., could not be used because of petroleum shortages. (U)

- o Methodology tends to under-estimate supply of raw materials (which can be stockpiled) but over-estimate primary manufacturing increases (which cannot). During the mobilization and war: (U)

    - o Overall manufacturing capacity is projected to increase by 14.7% annually. (U)

    - o Projected supply increases for most minerals are in the range of 1% to 3%. (U)

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4) Basic Materials Supply Response (U)

- Domestic Supply

  - Materials methodology considers only supplies available from existing domestic capacity, ignoring growth induced by wartime demand, reduced imports, higher prices and profitability of higher cost capacity: (U)

    - Proposed $88 million in cultured quartz crystals stockpile showed no wartime capacity increase despite 22% annual peacetime growth over 1970-80. (U)

    - FEMA's ferroalloys report assumed industry could add no capacity over four-year period, even though new furnaces can be added in 18-24 months. (U)

    - No domestic cobalt mining projected even though there are two domestic deposits which Interior estimates could yield 3 million tons annually within 2 years. (U)

    - Over the course of the war, FEMA assumes domestic antimony supplies decline 17% annually; copper, tin, zinc increase only 1% annually; nickel 2%; and lead 3% annually. (U)

- International Supply

  - Underlying war scenario assumes substantial reduction in NATO and Asian war zone industrial output, but materials projections implicitly assume: (S)

    - Minerals producing nations (Canada, Chile, Australia, South Africa) continue to ship to war zones at pre-war levels. (U)

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- Pre-war copper, lead, nickel, zinc exports to war zone would not be available to US. For example, in case of copper and lead exports from Chile, Canada, Peru, Mexico and Australia: (U)

Copper	Lead
o Nearly one-million tons to peacetime Europe (U)	o About 335,000 tons to peacetime Europe (U)
o Only 56,000 ton increase to wartime U.S. (U)	o Only 40,000 ton increase to wartime U.S. (U)

- Diversion of only one-third of peacetime Eurpoean copper supplies and 45% of lead supplies to U.S. would eliminate stockpile goals for these commodities entirely. The unfilled copper goal is $1.9 billion and lead goal is $.3 billion. (U)

- International supply assumptions are largely based on FEMA's complex political "reliability" ratings for 143 countries, which produce paradoxical results such as: (U)

  - Shortly before hostages were taken, Ayatollah's Iran (score 74.9) ranked higher than Ireland (score 74.6) or France (score 73.2). (S)

  - USSR (score 37.5) ranks higher than South Africa (score 26.3). (S)

  - The People's Republic of China (score 39.2), an assumed wartime enemy, was rated among the reliable suppliers. (S)

  - The unfilled stockpile goal for Jamaican bauxite ($.5 billion) could be eliminated if Jamaica (score 40) were considered a reliable supplier for essential civilian needs. (S)

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III. CONCLUSIONS AND RECOMMENDATIONS

- It is not clear that the postulated wartime policy instruments will produce the economic effects assumed, nor have they been systematically reviewed by Senior Administration economic policy officials at any time since 1981. This should be undertaken for the 1983 model update. (U)

- Present procedures appear to overestimate wartime civilian materials consumption and underestimate supplies, leading to excessive goals. (U)

- Unjustified goals produce pressure for acquisition (purchases, barter, conversions) of low-priority material while a number of high-priority defense requirements are not met. In effect, substantial USG stockpile assets may not be needed while other high priority materials are not available. (U)

- Based on a preliminary OMB analysis of 13 commodities with $17 billion goals, revision of FEMA's assumptions and procedures could reduce stockpile goals by 50-65 percent, $10-13 billion less than existing goals. Such reductions would not affect material requirements for direct or indirect military production. (U)

- CCEA should review FEMA's procedures and economic assumptions to ensure their validity and consistency with Administration economic policy and revised procedures should be used in computing new stockpile goals and in assessing national security preparedness related to imports. (U)

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